Statement by
Howard W. Hjort, Director
Agricultural Economics, Policy, and Budget
before the Credit Subcommittee
Committee on Agriculture, Nutrition, and Forestry
United States Senate
December 18, 1979

Mr. Chairman, I am pleased to appear before the Subcommittee to discuss how current high interest rates are affecting and will affect agriculture. Recent sharp increases in interest rates have generated concern and questions about impacts on production costs, land values, availability of loan funds to farms, and production of food and fiber. I will address these concerns, examining them within the context of the total set of economic forces bearing on agriculture.

Recent Interest Rate Developments

Short-term interest rates rose sharply in October to record-high levels, after the Federal Reserve System (Fed) altered its operating procedures to more effectively control excessive growth in the supply of money. The Fed moved toward more direct control of the money supply by:

- imposing reserve requirements on large certificates of deposit;
- increasing the discount rate (the rate charged by the Federal Reserve Banks to borrowing banks) by one percentage point; and
- initiating reserve requirements for United States banks on their borrowings of U.S. dollars from foreign banks (Eurodollars).

These requirements reduce the supply of funds to banks and make it more costly for them to borrow funds for relending to customers. Also, since some American banks have been borrowing dollars more cheaply abroad and relending them at higher domestic interest rates, it is now more difficult to circumvent policies which restrict the growth of domestic credit.

Short-term interest rates rose sharply after the monetary policy actions were taken in October. From an average of 11.75 percent in the third quarter of 1979, the prime rates of major banks--the rates quoted for loans to the most creditworthy borrowers--increased quickly to 14-1/2 percent and later peaked at 15-3/4 percent. Reductions to 15 percent have been announced by several banks in the last few days. Economic forecasters expect interest rates to decline moderately in the next several months but to remain above the inflation rate in 1980.

As we address concerns about the impacts of higher interest rates on farmers, we should remember that the Federal Reserve System took the steps it did to cool inflation, a more serious threat to farmers and indeed to the entire economic and social fabric of the country.

Current Interest Rates Charged Farmers

In assessing the impact of rising interest rates on agriculture, it is important to understand the relationship between agricultural interest rates and more highly-publicized rates such as "prime" at money center banks. Currently, interest rates charged farm borrowers average less than the prime rate. Some current rates are:

Long Term: Federal Land Banks, 9.75-10.0 percent (Stock Purchase Requirements increase the effective rate of interest to 10.5 to 11.0 percent).

Farmers Home Administration Farm Ownership, 10 percent.

Short Term: Banks 12 to 15 percent.

PCA's 11 to 12.5 percent.

These rates document that farm loan interest rates are not as responsive as business loans to changing economic conditions. Reasons

for the lower rates relate to the use of average cost pricing by the Farm Credit System and the ability of small rural banks to attract and hold small savers' deposits at rates well-below money center rates.

Interest Costs and Farmers' Use of Debt

This year, farmers are spending about $114 billion to cover annual production expenses, maintain their capital stock and expand the production capacity of the nation's farming sector. These expenditures are 16 percent greater than in 1978. They are expected to increase another 10 to 12 percent in 1980.

Farmers finance their production and capital expenses with net farm income, off-farm income, and borrowed funds. The importance of borrowed funds in that mix has been increasing. Of all the cash uses of funds by farmers, the percentage financed by net increases in both real estate and short-term debt has increased from under 6 percent in 1970 to more than 17 percent in 1978. In 1979 that dependence dropped to 15 percent because of higher net farm income; however, in absolute terms, net borrowings continued to increase. In 1970, farmers were adding about $2 billion a year to their net borrowings--debt. That figure was nearly $20 billion in 1979 and is expected to rise sharply in 1980.

Over this decade, the net additions to debt have remained about equally divided between real estate loans and non-real estate loans. In 1979, farmers paid $5.6 billion in interest charges on short-term debts and $6.3 billion on real estate debts.

The total interest cost of $11.9 billion in 1979 is about 25 percent higher than 1978's $9.5 billion in interest costs. Thus, interest costs rose faster than overall production expenses and were a net contributor to the inflation in farm costs of production this year. Interest charges now represent about 10 percent of total farm production expenses, and that per-

centage is gradually rising.

For 1980, interest costs are expected to rise nearly $2 billion--more than 16 percent--and again be a net contributor to the rate of increase in farmers' expenditures.

While higher interest rates have contributed to higher interest costs, the major source of interest cost increases has been the increasing use of debt financing. In 1980, if interest rates turn down from current-high levels as many major economic forecasters expect, most of the nearly $2-billion increase in interest charges will come from increased borrowing rather than higher interest rates.

It is important to note that while debts have been increasing, asset values have been rising. Farmers' equities have increased more than $100 billion in 1979. The ratio of debts to assets, in recent years, has varied little from the 16-to-17-percent range. This increase in value of assets of farmers should not be overlooked when assessing their well-being.

However, when interest rates are high, farmers worry most about their short-term liquidity and cash flow prospects. The ratio of debt outstanding to net farm income is one measure of the relative burden of debt against income. That ratio has risen considerably during the 1960's and 1970's. During the 1960's and early 1970's, debt outstanding was 2 to 3 times higher than net farm income. In 1977, debt was more than 5 times as large as net farm income. Since then, the ratio has fallen but still remains well over 4-to-1.

These aggregate numbers, for the total of all farms--large and small--can be misleading. The use of debt financing and the burden of farm debt are not evenly distributed. For example, the overall ratio of debts to

assets is about 17 percent. On small farms (sales of $2,500 or less), that ratio is only about 5 percent, but it increases for larger farms and is more than 20 percent for all farms with sales of more than $100,000.

Moreover, the distribution of off-farm income relative to debt outstanding is important. In 1978--the latest year for which complete data are available--farms with sales of $2,500 or less received nearly half the off-farm income to all farm families; yet, these farms owed less than 4 percent of the outstanding debt. At the other end of the scale, farms with sales of $100,000 and over owned nearly 40 percent of all debt outstanding but received only 6 percent of all off-farm income. Farms with sales of $40,000 and over accounted for more than 70 percent of all debt and had only 14 percent of all off-farm income.

These distribution numbers are important. Small and moderate sized farms finance more of their needs from internal sources which are augmented by large and growing amounts of off-farm income. The larger commercial farms ($40,000 and over sales)--about 20 percent of all our farms--produce more than 80 percent of the value of all farm products, incur about the same proportion of all production expenses owe more than 70 percent of all outstanding farm debt, and have to depend almost entirely on farm income to service that debt. Thus, these largest farms are most sensitive to costs of debt servicing and to changes in interest rates.

The Current Situation and Prospects for 1980

How inflation and the recent Fed actions affect interest rates and the supply of funds, varies by type of lender. For that reason, it is useful to review the situation for the major farm lenders. First, these general observations:

- o In the aggregate and for most local situations adequate loan funds appear to be available. That is, creditworthy producers will be able to obtain the loans they need. They will, of course continue to pay more for them. However, the total amount of money that farmers borrow in 1980 is not expected to be affected very much by the higher interest rates.

- o There will be some shifts in the mix of loan sources. As usually happens in periods of high interest rates and tight money supplies, the agencies of the Farm Credit System will increase their share of the market at the expense of commercial banks and life insurance companies. This shift results from the different legal, institutional and market forces bearing on the different lenders.

- o In general, most farmers pay lower interest rates than other borrowers. There are a number of reasons for this: rural banks operate in a market somewhat insulated from central money markets--though this insulation is now much less than in the past; agencies of the Farm Credit System (Federal Land Banks and Production Credit Associations) are able to charge less than prime rates in rising money markets by averaging the cost of new money in with money borrowed earlier at lower interest rates and then passing these average costs to borrowers in the form of variable rate loans--furthermore, the Farm Credit System is able to borrow at favorable rates in the money market; finally, the several Federal lending programs (FmHA, CCC, Small Business Administration) tend to lend at administratively determined rates which are nonetheless, closer to Treasury costs than to the higher prime rates. About one-third of the farm real estate debt is held by individuals who provided the financing to the buyer who purchased their farm. These rates are lower than those charged by commercial lenders.

Some argue that this partial insulation of farm credit markets distorts the allocation of funds in the general money markets and results in agriculture getting more than an optimal (or "desirable") share of capital during periods when monetary policy is restrictive. However, the continued availability of adequate loan funds to farmers has, no doubt, played an important role in improving the efficiency and productive capacity of U.S. agriculture and its ability to respond quickly to changing domestic and world needs.

With these general points, let me turn to the fund supply and interest rate situation for the major lenders.

A substantial number of rural banks are now faced with higher loan-to-deposit ratios because loan demand has exceeded growth in deposits. For instance, "agricultural banks"--those banks at which farm loans are 1/4 or more of total loans--account for only 6 percent of total banking resources but they held 51 percent of all farm loans in the banking system. Of such banks, more than half in some Federal Reserve districts had loan-to-deposit ratios higher than the banks desired. Some of these banks are curtailing their farm lending activity. There appears to be a growing tendency for banks to shift to variable interest rates and shorter maturity loans.

For example, between February 1977 and August 1979--a period of rising interest rates--average farm loan maturities at rural banks appear to have been shortened. These shorter maturities offer one method of changing rates more frequently.

Country banks have relied heavily on time deposits as a source of loanable funds in the past; and therefore, they were somewhat insulated from changes in interest rates in money market centers. However, when interest rates rise significantly above legal limits on savings account rates, depositors withdraw some funds to invest elsewhere.

However, to preserve deposits, banks, under regulations that took effect during 1978, have been able to offer money market certificates at almost as high a rate of return as direct investment would provide. A recent survey by the American Bankers Association showed that more than 85 percent of rural banks offer the certificates and find their customers make extensive use of the opportunity to invest in them. In fact, money market certificates comprise about 8.5 percent of the total resources at agricultural banks, compared with 4.2 percent at other banks.

On December 14, the Fed announced that beginning in January, 1980, banks and thrift institutions could begin offering money market certificates with no constraints on denominations and at interest rates established monthly, based on cost of money to the Treasury in the preceding month. The certificates' motive in two and one half years and interest may be compounded. The interest rate ceiling for banks will be 3/4 percentage point below Treasury costs and a new ceiling will be announced each month. This move is expected to improve the ability of banks and other thrift institutions to compete for savings and thus provide some relief to those banks whose loan-to-deposit ratios are so high that now loans are being rationed. However, this move also means higher costs for funds, higher interest rates for borrowers, and greater responsiveness of rural banks to changing economic conditions. All of this could also add further impetus to the trend toward variable interest rate loans by banks. In other words, the availability and cost for loan funds at rural banks will begin to follow those of banks in regional and national financial markets more closely.

Life insurance companies likely will reduce the funds available for agricultural lending partly as a result of high interest rates. For one reason, when interest rates are high, policyholders exercise their options to borrow against the cash value of their policies at the lower interest rates established by the policy contracts. Money market securities also offer higher interest rates and shorter terms than farm mortgage loans at fixed interest rates. All of these forces tend to reduce funds that insurance companies have for farm lending. There has been some discussion

of insurance companies shifting to variable interest rates, but little specific action.

Banks and insurance companies are presently unable to lend to certain customers at competitive rates in some states because of usury laws. While many states have revised their laws recently, there are still 12 states where agricultural lending by banks and insurance companies may be curtailed unless laws are changed. 1/

Production Credit and Federal Land Bank Associations are not expected to have difficulty with credit availability because their funds are borrowed in the national money market where they can be obtained at current market rates on securities of their recognized high quality. Because of this availability of funds and the fact that state usury laws do not apply to banks of the Farm Credit System, we expect farmers will increase the amounts borrowed from these agencies, relative to other lenders, during this period of high interest rates.

There has been a large growth in loan volume of the Farmers Home Administration (FmHA) and farmers will continue to have a strong incentive to seek FmHA financing. Rates for FmHA loans tend to lag short-term changes in financial market conditions. The rates are now attractive relative to those for other lenders. Bank and Production Credit Association rates on operating loans averaged 11.0 percent during the third quarter of 1979. FmHA loans will average about 9.5 percent for the same quarter but on November 1, these were raised one percentage point.

FmHA farm ownership loans are now 10 percent. Interest rates on disaster emergency loans vary, but average around 5 percent. FmHA interest

---

1/ Usury laws are either limiting or close to limiting credit availability in Alabama, Arkansas, Connecticut, Hawaii, Kansas, Louisiana, Nebraska, New Mexico, Ohio, South Carolina, South Dakota, and Wisconsin.

rates are closer to the rates charged by private lenders than they were before new legislation was enacted in 1978.

Budget allocations and lending policies, instead of money market conditions, will be the main factors governing availability of FmHA funds for farm loans.

Commodity Credit Corporation (CCC) price support loans have declined substantially during 1979, as much higher prices for the major support grain crops resulted in some withdrawals from the CCC-reserve stocks accumulated during previous years. Interest rates on CCC price support loans have been increased over the last year. The rate on the 1978-crop loans was 7 percent; loans on the 1979 crops carry a 9 percent rate. The rate on crop storage facilities and drying equipment is 10.5 percent, if the application for the loan was dated March 21, 1979 or later. Previously, the rate was 7 percent.

Impacts of Higher Interest Rates on Farmers' Decisions

The demand for operating inputs--feed, seed, fertilizer, pesticides, fuel, etc.--does not appear to be affected very much by variations in interest rates. Farm operators need to purchase these supplies to continue production. Many do not have adequate cash to finance such purchases and therefore must borrow the money. However, interest changes are a small part of the cost of production inputs and tend to have little impact on production decisions. For example, interest charges related to variable production costs are about 4 percent for wheat and 3 percent or less for all feed grains, cotton, peanuts, soybeans and rice.

Cash interest charges for feeding cattle have nearly doubled--from $14 to nearly $24 per head during the last year. But these changes are still small relative to other production costs, amounting to 3.3 percent of total costs

currently compared to near 2.6 percent last year. Interest rates have increased sharply during the past year, but higher costs of feeder cattle and feed relative to fat cattle prices are still the primary reason for lower net increases during the last half of 1979. Again, small changes in prices of feeder cattle, fat cattle and feed overwhelm cost changes related to higher interest rates and will be the dominate decision factors for cattle feeders.

Higher interest rates may also impact on farmers' marketing decisions in several ways. For example, if a farmer has borrowed money to finance production of a crop, high interest rates could be an incentive to market early, pay off the loan and thereby avoid incurring further interest charges. We also hear of some farmers selling their crops early rather than storing them and investing the proceeds in high interest money market certificates through local banks. Since the ultimate holders of inventories must realize enough gain to offset the income they could have received if they had chosen to invest in money market certificates, the main effect of these marketing pressures may be to increase the price differential between early season and late season marketing. Despite these potential effects, we expect relatively minor adjustments in marketing patterns because of higher interest rates.

Farm Machinery

Despite higher interest rates and 10-percent higher prices, sales of farm machinery increased in 1979 and are expected to continue strong into 1980. The credit subsidiaries of farm machinery companies report that the quality of their loans has remained very high in 1979 with practically no defaults or delinquencies. Crop farmers had a good income year in 1979 and this will continue to be the dominant influence in the farm machinery market through the winter. Most of the crop farmers will have another good year

in 1980. But, slower growth in cash receipts, continued inflation in production costs, and a replenished stock of new machinery on farms could combine with the fact that purchases of new machinery are a "postponable" expense to slow farm machinery sales in the second half of 1980 and into 1981. High interest rates thus could become a contributing factor rather than the dominant force in farm machinery sales next year.

Land

Other things equal, higher interest rates would slow the increase in land values. However, higher interest rates are only one of many factors which influence land prices currently and which interact in complex ways.

Among the most important of these are

- o expected returns from farming;
- o anticipated rates of inflation in land values;
- o the "thinness" of the land market (little land is offered for sale each year),
- o location value of specific parcels for particular buyers;
- o desire to expand existing farm businesses to more fully utilize excess machinery and other available resources, and
- o potential for high return, nonfarm uses.

The downward pressure on farmland prices due to higher interest rates has been more than offset by other factors. USDA surveys farmland value changes in February and November of each year. From February 1978 to February 1979 the average value of farmland sold increased 14 percent. Preliminary data suggests that the increase in land values from November 1978 to November 1979 was 17 percent. Current projections are that the February 1979 to February 1980 increase will be at least 16 percent.

Farmland markets are very "thin." During the 1970's, only 2 to

3 percent of the land in farms typically changed ownership each year. That percentage declined last year and declined still further this year. Thus, there are very few parcels for sale relative to the dollars available to purchase farmland and the number of people who want to buy farmland.

Several research reports indicate that increases in farmland values in recent years are consistent with annual increases in returns to land. Any asset--whether land or common stocks--which produces a growing annual return and which is expected to keep producing such a return will be priced by the market at a relatively-high multiple of that return. Hence, the income return to land is only about 5 percent of current market value. Given expectations of future growth in returns to land ownership, one would expect land prices to continue to rise but the income return as a percent of current market value to remain fairly low.

This explanation of land price increases has important implications for policy. With past land price increases now viewed as consistent with the record of current real earnings from owning land, current price levels can be regarded as based in large part on expectations of continued long-term growth in that return--which seems a reasonable expectation. In other words, the <u>expectation</u> of continued growth in returns to land and the <u>expectation</u> of continued inflation in land is bid into the current price of land. However, the low current earnings compared with the market value of land is an important source of many of the concerns being expressed by farmers--cash flow problems, difficult entry, and the attraction of farm real estate for persons of large wealth or high income.

Imagine trying to purchase land with borrowed money at 10 percent while current earnings are only about 5 percent! It is difficult to carry the loan in early years, but this problem eases as income increases over

time, but loan payments do not. The net result is a selectivity in the people who buy land. Individuals with substantial cash reserves or other sources of income can afford to carry the land investment in early years of the loan. This situation is actually quite comparable to housing where it is virtually impossible to invest in a single family residence and expect to make loan payments from the rent received on the house in the early years of the loan.

Policy actions designed to address these concerns need to be carefully structured. If policy actions increase the rate of growth in returns to land, prices will likely be bid up further and result in greater cash flow problems and increase the difficulty of entry for young operators.

Food Prices

Finally, the impact of high interest rates on food prices will come mainly from increased costs of farm production which ultimately must be reflected in prices of farm commodities. Higher interest rates will have little impact on the food processing and distribution sectors. A 15-percent increase in interest rates, for example, translates into only a .1 or .2 percent increase in the food marketing bill.

Summary

Higher interest rates must have some obvious impacts on the farming sector. We are particularly concerned about rising production costs and about potential debt servicing problems for those farmers who have recently invested heavily in expanded production capacity. New farms without substantial build-up of equity are likely to be especially vulnerable to the effect of higher interest rates. As a result of that vulnerability and of a reduced amount of land available for sale--in part contributable to higher interest

rates--there may be a decline in numbers of beginning farmers next year, even from presently-low levels of entry.

Because of differences in state usury laws and differences in the loan-to-deposit conditions of rural banks, there will be more restrictions of bank and insurance company lending in some regions than in others. Some farmers will have to find new sources of credit.

Finally, the interest rate and credit situation must be viewed in the context of the overall financial health of the farm sector. I believe that health to be generally strong. Farm income in 1979 will be the second highest on record. For 1980, prices of most grains will remain high despite record large production. Income prospects in 1980 look strong for producers of food grains, feedgrains, fruits and vegetables, feeder cattle and dairy products. Incomes for cotton and soybean producers could be moderately lower. Prospects for hog producers, cattle feeders and poultry producers are less favorable, although these prospects look better now than they did a month ago.

Looking beyond 1980, the prospects for the farm sector are quite optimistic. Foreign demand is strong and likely to continue to grow. Our markets are not over-shadowed by price-depressing surpluses or large acreages of land artificially held out of production. The cattle cycle is in the rebuilding stages, portending strong cattle prices for several years to come. The 1980's could be a very good decade for U.S. farmers.

A dark cloud on the horizon is the persistent inflation in farm expenses which threatens to erode gains farmers may make in the marketplace. This threat re-emphasizes the importance to the long-run health of American agriculture of supporting policies designed to eventually bring inflation under control.

For the record, I am providing copies of the Department's recently published "Agricultural Finance Outlook" which reviews the financial situation of the farm sector in detail and contains many useful tables and figures.

Mr. Chairman and members of the Committee, I will try to respond to your questions.

- - - - -